

Board of Governors of the Federal Reserve System

AUDIT OF RETIREMENT PLAN ADMINISTRATION



OFFICE OF INSPECTOR GENERAL



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

July 31, 2003

Board of Governors of the
Federal Reserve System
Washington, DC 20551

Dear Members of the Board:

We are pleased to present our *Report on the Audit of Retirement Plan Administration* (A0208). We included this project in our 2002 audit plan as a follow-on to audit work we performed in 2001 during which we identified several discrepancies in pension-related information for employees of the Board of Governors of the Federal Reserve System (Board). Our specific objectives of this audit were to document and obtain an understanding of the retirement process for Board employees; assess the effectiveness of processes for monitoring vendor contracts and vendor performance; evaluate automated system controls and confirm the accuracy of employee data; determine whether Board employees and other key stakeholders are generally satisfied with the customer service provided; and obtain an understanding and evaluate the effectiveness of the governance structure for the retirement plan.

Our review of the retirement process and vendor contract management, as well as our data verification and pension benefit recalculations, did not identify any significant control weaknesses, data discrepancies, or systemic processing errors. We found that staff in the Management Division (MGT) have worked with the Office of Employee Benefits (OEB) and the outsourcing contractor over the past two years to improve the accuracy of pension-related information, and to help the contractor to become more familiar with aspects of the retirement plan. Our testing identified three minor discrepancies in pension benefit amounts for the retirees in our sample. We provided this information to MGT staff and the necessary adjustments have been made. In addition, our customer satisfaction surveys showed that Board staff were generally satisfied with the retirement process and the accuracy of information received. However, we received several comments related to the availability and communication of retirement plan information and have included them in a separate management letter report.

Although we did not identify any significant weaknesses or systemic errors, we believe that opportunities exist to strengthen the retirement plan administration and oversight. Specifically, we found that the methodology for including lump sum payments in final average salary calculations for members of the Board Benefit Structure does not ensure that retirees receive full credit for payments received. We also found that the methodology for allocating OEB expenses to the Board and Reserve Banks does not provide an equitable distribution of expenses. We are classifying as questioned costs \$585,630 in expenses paid, or expected to be paid, by the Board in 2003 for benefits programs in which the Board is not participating. We are also classifying as

funds for better use \$1.726 million in projected savings for 2003 through 2005 that would result from the implementation of our recommendation. We also believe that the continuing role of the MGT staff in retirement processing is unclear and that the audit committee for plan administration is inappropriately positioned. Our four recommendations describe policy decisions that the Board, either through the Committee on Board Affairs or through the Board's representation on other oversight committees, needs to make to strengthen oversight and administration of the retirement plan.

We provided our report to the Staff Director for Management for comment. The Staff Director's response, included as appendix 1, concurs with recommendations 1 and 3 and outlines actions that will be taken to address the recommendations. The Staff Director concurred in part with recommendation 2, agreeing that the methodology for allocating OEB expenses should be modified for those benefits programs in which the Board is not participating. The Staff Director disagreed that the current cost-allocation methodology—based on salary liability—is flawed, noting that the Committee on Plan Administration (CPA), which has responsibility for selecting a cost allocation methodology, endorsed the use of this method as recently as 1999. The Staff Director noted, however, that a Federal Reserve System (System) work group is reviewing this issue and will report its findings to the CPA; the Board will rely on the CPA's decision. We continue to believe that the use of staffing levels versus salary levels is a more equitable and defensible basis for assessing expenses. The Staff Director also disagreed with our recommendation to establish a separate audit committee (recommendation 4), although he noted that interaction and communication between the primary existing committees is key to effective retirement plan oversight. The Staff Director plans to refer this issue to the System's Conference of Presidents for review. We continue to believe that establishing a separate audit committee is the most effective method of strengthening oversight, although enhancing communication between committees, particularly with regard to audit-related activities, would be beneficial.

We also provided copies of our report to other Board and System officials with oversight responsibilities. The director of the Division of Reserve Bank Operations and Payment Systems provided a written response addressing part of recommendation 2 and recommendation 4. The director's response, included as appendix 2, generally parallels the Staff Director's response regarding the adoption of a different allocation methodology and the creation of a separate audit committee. The division also provided a separate response containing technical comments on the report. We have incorporated several of these comments into the report to provide additional clarity, although the comments did not alter the recommendations or materially change any of the report's information.

We have provided copies of this report to Board and System officials and the report will be added to our publicly available web site at www.federalreserve.gov/oig. We will also summarize the report in our next semiannual report to the Congress. Please contact me if you would like to discuss the audit report or any related issues.

Sincerely,

/signed/

Barry R. Snyder
Inspector General

Enclosure

cc: Mr. Jack Guynn
Mr. Richard Radsall
Mr. Paul McAuliffe
Mr. Stephen Malphrus
Ms. Louise Roseman

Board of Governors of the Federal Reserve System

AUDIT OF RETIREMENT PLAN ADMINISTRATION



OFFICE OF INSPECTOR GENERAL

TABLE OF CONTENTS

	Page
BACKGROUND.....	1
OBJECTIVES, SCOPE AND METHODOLOGY.....	3
FINDINGS AND CONCLUSIONS	4
ANALYSIS OF COMMENTS	11
APPENDIXES	13
Appendix 1 – Comments from the Staff Director for Management	15
Appendix 2 – Comments from the Director of the Division of Reserve Bank Operations and Payment Systems	17
Appendix 3 – Principal Contributors to this Report.....	19

BACKGROUND

Retirement Plan Overview

The retirement plan for employees of the Federal Reserve System (System) is a defined benefit pension plan established to provide pension benefits to eligible employees of the Federal Reserve Banks and the Board of Governors of the Federal Reserve System (Board). The retirement plan consists of two benefit structures: the “Benefit Structure for Employees of the Board of Governors of the Federal Reserve System Hired Prior to January 1, 1984” (the Board Benefit Structure) and the *Retirement Plan for Employees of the Federal Reserve System* (the Bank Plan).¹ The Board Benefit Structure covers Board employees hired prior to 1984, as well as Board employees hired after 1983 who transfer their participation in the Civil Service Retirement System (CSRS). The Board Benefit Structure generally mirrors CSRS provisions and employees covered by this structure are required to contribute 7 percent of their salary in lieu of making contributions to Social Security. The Bank Plan covers employees of the Federal Reserve Banks and most Board employees hired after 1983. The Bank Plan mirrors private sector plans and is primarily funded through employer contributions. As of October 31, 2002, there were 485 Board staff covered by the Board Benefit Structure and 1,207 Board staff covered by the Bank Plan.² JP Morgan Chase serves as the trustee and custodian for all of the retirement plan assets, and, along with eight investment managers, manages the plan’s investments.

From a benefit payment perspective, there are several significant differences between the Board Benefit Structure and the Bank Plan. Employees covered by the Board Benefit Structure are eligible to receive full retirement at an earlier age (age 55 with thirty years of service versus age 60 with comparable service for Bank Plan retirees) and can use accumulated sick leave to increase their total years of creditable service. The percentages used for computing pension benefit amounts under the Board Benefit Structure are more generous than those under the Bank Plan; however, Bank Plan employees pay social security taxes and earn social security credits. In addition, an employee’s final average salary (the basic component of the pension benefit calculation) includes the highest average salary over three consecutive years under the Board Benefit Structure, while the Bank Plan uses a five-consecutive-year timeframe.

Retirement Plan Oversight and Administration

Along with the plan documents, the *By-Laws Relating to the Administration, Amendment, and Oversight of the Plans Comprising the Federal Reserve Employee Benefits System* (By-Laws) establish the oversight structure for the retirement plan, as well as other System benefit plans such as the Thrift Plan, the Long Term Disability Plan, and the Personal Accident Insurance

¹ The Board Benefit Structure is actually an appendix to the Bank Plan; we collectively refer to the two structures as “the plan documents” in this report. The plan documents were most recently amended and restated as of January 2002.

² A few Board employees are covered by other retirement programs, including CSRS and the Federal Employee Retirement System.

Plan. The current By-Laws, adopted in August 1999 and last amended in July 2002, establish three committees, each with specific responsibilities, to oversee the benefit plans:

- the Committee on Employee Benefits (CEB) provides strategic direction and plan design;
- the Committee on Plan Administration (CPA) provides administrative direction and operational oversight; and
- the Committee on Investment Performance (CIP) provides plan asset investment oversight.³

As shown in the table below, each committee consists of five members from the Board and the Reserve Banks.

Table 1 Membership in Benefit Plan Committees

	CEB	CPA	CIP
Membership	2 Governors 3 Reserve Bank Presidents	2 Board Officers 3 Reserve Bank Officers	1 Governor 3 Reserve Bank Presidents 1 Reserve Bank Officer
Committee Chair	Elected by committee members	Selected by the CEB	Elected by committee members

Although the committees are responsible for establishing the guidelines, policies, and procedures related to the retirement plan and other benefit plans, the Office of Employee Benefits (OEB) has responsibility for administering the plans and implementing the guidance established by the committees. OEB's responsibilities include ensuring that the plans and their administration comply with applicable laws and regulations; obtaining interpretations of the provisions of the plans and providing answers to related legal and actuarial issues; and developing effective ways to communicate plan benefits. OEB reports to the three oversight committees who appoint the OEB executive director, approve OEB's budget (subject to the Board's approval process for Reserve Bank budgets), and monitor OEB's performance. The office currently receives administrative support (including personnel and information technology support) from the Federal Reserve Bank of New York (FRB NY). In 2000, OEB outsourced most of the administrative and processing functions for the retirement plan to Hewitt Associates (Hewitt). Hewitt is a global outsourcing and consulting firm that provides a complete range of human capital management services, including benefits outsourcing, human resources strategy and technology, and retirement and financial management. Administrative and processing responsibility for the thrift plan and other benefit plans have also been outsourced to Hewitt.

³The By-Laws also create a fourth committee: the Directors' Committee. This committee consists of five Reserve Bank directors and has the authority to comment and make recommendations on certain proposed changes to the plan.

OEB is responsible for monitoring Hewitt's performance against the performance measures established in the outsourcing contract.

Audit responsibility for OEB and the benefit plans rests with several internal and external entities. An independent accounting firm performs the financial statement audits for OEB as well as for the plan assets; selection and oversight of the external auditors is the CPA's responsibility. FRB NY currently provides OEB's internal audit function and looks at internal controls and compliance with System policies and procedures. The Board's Division of Reserve Bank Operations and Payment Systems (RBOPS) conducts periodic examinations of OEB's operations as part of its Reserve Bank oversight function. In addition, OEB recently hired an internal management auditor to perform operational reviews, audits, and other projects related to the various benefit plans and OEB's internal operations. Although employed by OEB, the management auditor also has a reporting responsibility to the CPA.

At the Board, the Management Division (MGT) has primary responsibility for the benefits programs. The division's Human Resources Function is responsible for designing, maintaining, and communicating the Board's benefits package and for ensuring that all benefits programs are cost effective, well communicated, and compliant with all relevant laws and regulations. The division's Finance Function has responsibility for providing payroll information and other data transmissions to Hewitt.

OBJECTIVES, SCOPE, AND METHODOLOGY

In 2001, the OIG participated with the Reserve Bank General Auditors in an audit of OEB. The audit included a recalculation of pension payments from a sample of retired employees throughout the System and a verification of pension-related information for active employees. The limited work we performed in support of the audit identified several discrepancies in the pension-related information for Board employees. As a result of that effort, we decided to conduct an audit that focused more in-depth on administration of the retirement plan for Board employees. Our specific audit objectives were to

- document and obtain an understanding of the retirement process for Board employees under both the Bank Plan and the Board Benefit Structure;
- assess the effectiveness of OEB's processes for monitoring vendor contracts and vendor performance;
- evaluate automated system controls and confirm the accuracy of employee data maintained by Hewitt;
- determine whether Board employees and other key stakeholders are generally satisfied with the customer service provided by Board, OEB, and Hewitt staffs; and
- obtain an understanding and evaluate the effectiveness of the governance structure for the retirement plan.

We conducted our audit fieldwork from October 2002 to April 2003. To achieve our objectives, we reviewed the By-Laws, plan documents, and other related materials. We interviewed managers and staff at the Board, OEB, and Hewitt, and met with members of the CEB and the CPA. We reviewed vendor contracts related to plan administration, focusing primarily on the contract with Hewitt. To evaluate automated controls and confirm data accuracy, we selected a judgmental sample of fifteen active Board employees and forty-one Board retirees; our sample included individuals covered by the Board Benefit Structure as well as the Bank Plan. We included all individuals retiring from the Board during 2002 in our sample. For both active employees and retirees, we verified data from Hewitt's automated system to supporting information maintained MGT. Specifically, we verified birth dates, hire dates, creditable service, and salary information. For the retirees, we also recalculated their final average salary and pension benefit amounts and verified our results with the information provided by Hewitt. In addition, we surveyed seventeen individuals included in the sample to ascertain their satisfaction with the level of customer support received relative to retirement plan administration. Our audit was conducted in accordance with generally accepted government auditing standards.

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

Our review of the retirement process and OEB's contract management, as well as our data verification and pension benefit recalculations, did not identify any significant control weaknesses, data discrepancies, or systemic processing errors. We found that the MGT staff have worked over the past two years to improve the accuracy of pension-related information. MGT staff and OEB have also worked with Hewitt to help the contractor become more familiar with aspects of the Board Benefit Structure and the Bank Plan, although Board staff still have concerns about Hewitt's understanding of Board Benefit Structure provisions and related retirement processing. Our testing identified three minor discrepancies in pension benefit amounts for the retirees in our sample; we provided this information to the MGT staff who worked with Hewitt to ensure that the necessary adjustments were made. In addition, our customer satisfaction surveys showed that staff were generally satisfied with the retirement process and the accuracy of information received, although several individuals commented on the limited amount of, and access to, available pension-related information. We provided the detailed responses to our satisfaction survey to plan management in a separate letter report, along with our suggestions for providing Board staff with enhanced communication and more robust information related to retirement planning and processing.

Although we did not identify any significant weaknesses or systemic errors, we believe that opportunities exist to strengthen retirement plan administration and oversight. Specifically, we found that:

- the methodology for including lump sum payments in final average salary calculations for members of the Board Benefit Structure does not ensure that retirees receive full credit for payments received;

- the methodology for assessing OEB expenses to the Board and Reserve Banks does not, in our opinion, provide an equitable distribution of expenses; and as such, we have classified \$585,630 in expenses for 2003 as questioned costs and \$1.726 million for 2003 through 2005 as funds for better use;
- the continuing role of the MGT staff in retirement processing and the appropriate level of data access is not clear; and
- the audit committee for plan administration is, in our opinion, inappropriately positioned and a charter has not been developed to clearly identify the committee's membership, roles, and responsibilities.

The four recommendations below address each of these issues in more detail.

1. We recommend that the Board, through its representation on the CPA, modify the methodology for including lump sum payments in pension benefit calculations for members of the Board Benefit Structure.

Beginning in 2002, the definition of salary for retirement benefit calculations was expanded to include lump sum merit increases, cash awards, and incentive pay (collectively referred to as lump sum payments). Individuals covered by the Board Benefit Structure and the Bank Plan now receive credit for lump sum payments when their final average salary is calculated, although the specific methodology differs for the two benefit structures.

Based on our recalculation of pension benefit amounts for the retirees in our sample, we found that Hewitt's methodology for computing the final average salary for members of the Board Benefit Structure may result in individuals not receiving full credit for lump sum payments. (We did not identify any issues with the calculations for Bank Plan participants.) The final average salary for Board Benefit Structure participants is based on an individual's highest salary for three consecutive years. The calculation assumes a 360-day year (i.e., twelve thirty-day months), consistent with the methodology used for CSRS retirees. If an individual receives a lump sum payment during one of those three years, that payment is treated as if it were part of the retiree's salary for one payroll period for purposes of calculating final average salary. Specifically, the lump sum is converted to an annual amount, added to the individual's regular annual salary, multiplied by a standard factor, and the revised amount is credited to the retiree for one payroll period. A retiree should, therefore, receive fourteen days of credit (the equivalent of one payroll period) for the lump sum payment.

We found, however, that if the payroll period in which the lump sum payment is received crosses the end of a month with thirty-one days, the individual only receives credit for a thirteen-day payroll period since the methodology assumes a thirty-day month. Although the difference may be minimal if the lump sum payment is small, the difference can be significant for larger payments. The table below shows the differences between a thirteen-day credit and a fourteen-day credit for varying cash award amounts.

Table 2 Final Average Salary Calculations with Cash Award

Annual Salary	Cash Award	Annualized Cash Award (Award x 26 pay periods)	Total Annualized Compensation for Purpose of this Calculation	Final Average Salary – 14 Days of Credit¹	Final Average Salary – 13 Days of Credit	Difference
\$100,000	\$2,000	\$52,000	\$152,000	\$5,910.97	\$5,488.87	\$422.10
100,000	5,000	130,000	230,000	8,944.24	8,305.53	638.71
100,000	8,000	208,000	308,000	11,977.50	11,122.18	855.31

¹ The standard factor for converting an annual amount to a fourteen-day period is 14/360 or .038889; the factor for a thirteen-day period is .036111.

Seven of the thirty-two Board Benefit Structure retirees in our sample (22 percent) received only thirteen days of credit for their lump sum payments. We recalculated what the final average salary would have been if these individuals had received full credit for the payment, and found that the current methodology resulted in the final average salary for these seven individuals being reduced between \$11 and \$200. The effect on an individual's pension benefit was to reduce the benefit between \$1.20 and \$10.76 per month, depending on the amount of the lump sum payment received.

Our recalculations also showed that an individual may receive less than a full fourteen-day credit if the lump sum payment is received shortly before the individual's retirement date. Therefore, if an individual retires less than fourteen days after Hewitt is notified on a lump sum payment, the individual will receive less than fourteen days of credit toward their final average salary, even though the payment actually corresponds to an earlier two-week payroll period.

We believe that the Board, through its representation on the CPA, should require Hewitt to revise the methodology for crediting lump sum payments to ensure that retirees receive full credit. We recognize that this change could require reprogramming of Hewitt's system, and that the cost of doing so may seem prohibitive, given that this anomaly only affects individuals covered by the Board Benefit Structure and the resulting adjustments are not large relative to the total pension payments. However, the potential for underpayment, even if the amount is small, in our opinion represents a potential liability for the Board, and the costs of reprogramming should be evaluated in that context. As an alternative, the Board may want to explore requiring Hewitt to intervene manually in the process for all Board Benefit Structure participants who receive a lump sum payment. In addition, to ensure equitable treatment, the Board should direct OEB to review all Board Benefit Structure retirees since January 1, 2002, to determine whether any pension benefit amounts should be adjusted to provide full credit for lump sum payments received.

2. We recommend that the Board, through its representation on the CEB and the CPA, revise the methodology for allocating OEB expenses.

OEB's operating and capital expenses are fully reimbursed in one of two ways. Expenses directly linked to retirement processing and administration are reimbursed directly from the retirement plan assets. These expenditures are reviewed and approved by the CPA on a quarterly

basis. The remaining expenses, which include costs associated with administering all of the benefits programs for which OEB is responsible, are reimbursed by the twelve Reserve Banks and the Board (collectively referred to as the employers). At the beginning of each quarter, the employers are assessed a percentage of OEB's budgeted expenses. The assessment is based on salary liability; i.e., each employer's salary liability is computed as a percentage of the total employers' liability, and this percentage is used to assess expenses. As part of the quarterly assessment, employers are also charged individually for any expenses incurred in direct support of a specific employer, such as a request for a correction or a special report.

We believe that the current methodology for assessing expenses is flawed in two ways. First, under the current assessment methodology, all costs are assessed back to the employers, regardless of which benefit program(s) generated the costs. Since the Board has chosen not to participate in all of the consolidated System benefits programs, such as the health and welfare program, we believe that the Board should not be required to bear the costs associated with these programs. During 2003, for example, the Board will be assessed approximately \$585,630 for expenses related to administration of the consolidated health and welfare program. (This is the first year in which health and welfare expenses will be incurred.) We understand that a System working group has been looking at this issue and plans to recommend that the Board not be charged for these expenses beginning in 2004. However, we do not believe the Board should be charged these expenses in the current year, and we are classifying \$585,630 as questioned costs.

The second flaw in the assessment methodology is that assessing expenses based on salary liability results in an inequitable distribution, with the Board and FRB NY paying a disproportionately higher amount. We found no indication that an employee's salary level has a direct correlation to the volume of transactions processed, the frequency of interactions with OEB and Hewitt, or any other performance measure that would justify salary as the allocation basis. Instead, we believe that using each employer's average number of personnel (ANP) is a more equitable and defensible basis for assessing expenses. Higher staffing levels are, in our opinion, more likely to directly correlate to the volume of payroll transactions processed, calls to OEB or Hewitt, or other factors affecting total expenses. We compared the two assessment methods and found that the Board's assessment percentage for 2003 would have decreased from almost 10 percent to approximately 7 percent if ANP was used in lieu of salary liability. This would have reduced the Board's total expenses by \$575,224 for 2003. As shown in the table below, changing the methodology from salary liability to ANP would decrease 2003 expenses for the Board and three Reserve Banks, with the other nine Reserve Banks experiencing an increase. We are classifying \$1,725,672 as funds for better use since implementing the revised methodology, consistent with our recommendation, would reduce the Board's outlays for the current year and the next two-year budget period.⁴

⁴ The total funds for better use includes \$575,224 for 2003 and a projected savings of \$1,150,448 (twice the 2003 figure) for the 2004-2005 budget period. Because OEB's budget for this period was not finalized as of the date of our report, we projected savings for this two-year period based on savings identified for the current year.

Table 3 Comparison of Total Assessments for 2003¹

Employers	Total Assessment at ANP	Total Assessment at Salary Liability	Difference
Boston	\$1,051,780	\$1,067,577	\$(15,797)
New York	2,663,335	3,350,731	(687,396)
Philadelphia	997,685	874,190	123,495
Cleveland	1,103,509	866,296	237,213
Richmond	2,296,794	2,255,527	41,267
Atlanta	1,922,068	1,669,445	252,623
Chicago	1,659,936	1,626,032	33,904
St. Louis	1,054,985	886,030	168,955
Minneapolis	1,018,578	935,363	83,215
Kansas City	1,392,481	1,213,604	178,877
Dallas	1,208,655	1,022,190	186,465
San Francisco	1,983,236	2,010,833	(27,597)
Board of Governors	1,380,356	1,955,580	(575,224)
Totals	\$19,733,398	\$19,733,398	\$0.00

¹ These figures do not include estimated health and welfare expenses for 2003.

The CPA has responsibility for determining the methodology for assessing OEB's expenses to the employers, and the CEB is responsible for approving the CPA's methodology. The Board, through its representation on these committees, should revise the current methodology to provide a more equitable distribution. This includes using ANP as the basis for computing the allocation percentage, as well as ensuring that employers are only charged for expenses pertaining to those programs in which they participate. Such a change will require different percentages for Systemwide programs and those benefits programs applicable to a subset of the employers.

3. We recommend that the Committee on Board Affairs (CBA) establish clear guidance for the continuing role of MGT staff to support retirement processing and to ensure that staff have access to Hewitt information commensurate with that level of support.

The contract with Hewitt requires the contractor to provide administrative, record keeping, and related services in connection with the System's retirement plan. These services include maintaining retirement-related data, providing an Internet site for employees to perform retirement planning and initiate the retirement process; processing the paperwork necessary for an employee to begin receiving pension benefits, and providing annuity payment information to the plan trustee. In addition to the Internet site, Hewitt also maintains a voice response system and a central call center with service representatives to answer questions and provide retirement-related information.

Although the administration and processing functions were outsourced to Hewitt almost three years ago, we found that support of, and participation in, the retirement process by MGT staff is still in a state of transition. MGT staff provide limited support for retirees covered by the Bank

Plan, but continue to provide a higher level of support for Board Benefit Structure participants. For example, MGT staff prepare estimates of retirement benefits, review retirement information with Board staff, and assist staff in resolving questions or difficulties with Hewitt.

We are concerned that MGT's continuing to maintain a strong presence in the retirement process, even if only for a small group of individuals, potentially duplicates some costs since the same function is being performed by the contractor and by Board staff. Maintaining this presence also reinforces the paradigm that MGT is the focal point for retirement processing, thus perpetuating their involvement beyond Board Benefit Structure participants. We found, for example, that all of the retirees in our sample began the retirement process with MGT, and almost all of the active employees we spoke with, regardless of which structure they belonged to, stated that they would contact MGT if they had retirement questions. MGT's presence also appears inconsistent with Systemwide initiatives to reduce human resources support costs, including costs associated with benefits processing.

We believe that the CBA needs to establish the proper role for the MGT staff in the retirement process. We recognize that concerns exist about Hewitt's ability to maintain the same level of proficiency with Board Benefit Structure provisions (which currently affect between 400-500 Board employees) compared to the Bank Plan (which affects over 20,000 people Systemwide). Given that the Board Benefit Structure participants are long-term Board employees, including many officers and other senior-level staff, the CBA may decide that the value of providing this service outweighs the cost of MGT's participation. The CBA should determine whether MGT's participation will be limited to Board Benefit Structure participants, or whether it should be extended to cover all Board retirees, since even those covered by the Bank Plan encounter special situations not found elsewhere in the System (e.g., prior government and military service). In making its decisions, however, the CBA should consider any direction provided by the Board to the Reserve Banks' human resources departments regarding retirement processing.

If the committee decides that the MGT staff should continue to perform a role in the retirement process, then we believe they should be given greater access to Hewitt's on-line database. Currently, the MGT staff has access only to a Hewitt database containing limited information that is updated infrequently. We believe that the MGT staff should be given access to the same on-line database used by Hewitt's in-house counselors to ensure that the MGT staff have access to the most up-to-date and reliable information for assisting potential retirees. Because this database contains Systemwide personnel data, only one or two MGT staff would need to be granted access, consistent with the level of retirement processing support designated by the CBA.

- 4. We recommend that the Board, in concert with the Conference of Presidents, strengthen oversight of the retirement plan by (1) amending the plan documents and By-Laws to create an audit committee composed of members of the CEB, CPA, and CIP; and (2) establish a written charter to clearly define the audit committee's roles and responsibilities.**

Oversight of the retirement plan as well as the other benefit plans is accomplished through a multilevel structure involving governors, Reserve Bank presidents, and other senior System staff.

Primary oversight comes from the CEB, the CPA, and the CIP, although additional oversight and direction come from the Board's Committee on Reserve Bank Affairs, the System's Committee on Personnel and Subcommittee on Human Resources, and the Directors' Committee. Members of the CEB and CPA to whom we spoke with were generally satisfied with the oversight process, as were staff at OEB. However, all parties recognized that the interaction and communication between the primary committees were key to effective oversight.

As part of our review of this multilevel oversight structure, we looked at oversight of the audit function for OEB and the retirement plan and assets. This function is currently performed by the CPA. In this capacity, the CPA hires and oversees the external auditor, maintains a direct reporting relationship with the internal management auditor, meets with all audit and review entities on a periodic basis, and receives reports from all audit and review entities and monitors actions taken on recommendations. The committee also recently reviewed the overall audit structure and made recommendations to minimize redundancies and ensure better coordination and communication among the responsible audit groups, OEB, and the CPA.

While we commend the CPA for its work in this area, we believe that oversight of the audit function can be strengthened. We believe that having only the CPA serve as the audit committee provides insufficient representation of plan interests. Although the CPA briefs the other committees on audit plans, results, and the status of actions taken, we believe that having representatives of all three committees interact directly with the various audit entities will help ensure that all aspects of plan administration are more effectively addressed. This would allow any strategic or investment-related concerns to be appropriately incorporated into audit plans or to be discussed between the auditors and the cognizant committee member when audit results are presented. In addition, broadening representation on the audit committee will, in our opinion, help ensure that the committee maintains a proper level of independence. As recent congressional and industry actions have shown, establishing an audit committee that is independent from management in both fact and appearance is crucial to the committee's effectiveness. While we recognize that the CPA is separate and distinct from OEB management, the committee's responsibilities as outlined in the plan documents and By-Laws give it the most day-to-day administrative functions of any of the three primary oversight committees. Many of the committee's responsibilities appear to be more in keeping with providing direction than providing oversight; several of the committee's primary functions require the approval of the CEB. We are concerned that this creates the perception that the CPA is insufficiently removed from the managerial function to interact impartially with the auditors and independently oversee implementation of audit recommendations.

We recommend that the Board, in concert with the Conference of Presidents, revise the By-Laws to create an audit committee that includes representation from the CEB, the CPA, and the CIP. The audit committee could, for example, include the chairs of the other three committees, although the composition should include at least one member with a strong financial/accounting background, in keeping with current industry guidelines, and should have representation from both the Board and the Reserve Banks. The Board should also amend the By-Laws to create a charter for the audit committee that clearly defines not only the membership but also its significant duties and responsibilities. These should include all aspects of the committee's relationship (selection, oversight, and communication) with the external auditor(s) and

reviewers, the Reserve Bank general auditor providing internal audit support, and OEB's internal management auditor. The charter should also delineate the committee's other financial management responsibilities, including responsibility for accounting policies, risk management, and internal controls.

ANALYSIS OF COMMENTS

We provided our report to the Staff Director for Management for comment. In his response, included as appendix 1, the Staff Director welcomed our recommendations on actions to strengthen plan administration and oversight, but noted that final decisions on two of the recommendations require action by other System entities. The Staff Director concurred with recommendation 1 and plans to work with the CPA and OEB to ensure lump-sum payments are appropriately considered in future pension benefit calculations. The Staff Director also concurred with recommendation 3 and plans to seek guidance and direction from the CBA regarding the continuing role of MGT staff in support of retirement processing.

The Staff Director concurred in part with recommendation 2. Specifically, he agreed that the methodology for allocating OEB expenses should be modified for those benefits programs in which the Board is not participating and he plans to ask the CPA to exclude these expenses from the Board's assessment for 2003 and future years. The Staff Director disagreed that the current cost-allocation methodology—based on salary liability—is flawed. His response noted that the CPA, which has responsibility for selecting a cost allocation methodology, endorsed the use of this method as recently as 1999. The Staff Director indicated, however, that a System work group is reviewing this issue and will report its findings to the CPA; the Board will rely on the CPA's decision. We continue to believe that the use of staffing levels is a more equitable and defensible basis for assessing expenses. We will review the CPA's final decision as part of our follow-up audit work.

The Staff Director also disagreed with our recommendation to establish a separate audit committee (recommendation 4), and stated that the current governance structure, including actions taken by the CPA in performing its oversight responsibilities, provides for independent and comprehensive audits of the retirement plan. However, the Staff Director also noted that interaction and communication between the primary existing committees is key to effective retirement plan oversight. He plans to refer this issue to the System's Conference of Presidents for review. As our report indicates, we believe that having only the CPA serve as the audit committee provides insufficient representation of retirement plan interests and that the CPA's current administrative functions could create the perception of insufficient independence from OEB management. We continue to believe that establishing a separate audit committee is the most effective method of strengthening oversight, although we agree that enhancing communication between committees, particularly with regard to audit-related activities, would be beneficial.

We also provided copies of our report to other Board and System officials with oversight responsibilities. Only the director of RBOPS provided a written response which is included as appendix 2. The director's response addresses part of recommendation 2 and recommendation 4,

and generally parallels the Staff Director's response regarding the allocation methodology and the creation of a separate audit committee. The director believes that the current methodology for allocating expenses is not "manifestly unreasonable", and she takes issue with our classifying \$1.7 million as funds for better use. As noted in our report, we found no specific performance measure that would justify using salary level as the allocation basis; changing the methodology to one based on ANP would, over a three-year period, reduce the Board's expenses by approximately \$1.7 million. RBOPS also provided a separate response containing technical comments on the report. We have incorporated several of these comments into the report to provide additional clarity, although the comments did not alter the recommendations or materially change any of the report's information.

APPENDIXES

Appendix 1 – Comments from the Staff Director for Management

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551



STEPHEN R. MALPHRUS
STAFF DIRECTOR FOR MANAGEMENT

July 23, 2003

TO: Barry Snyder

FROM: Steve Malphrus (**signed**)

SUBJECT: Comments on the draft OIG Report, *Report on the Audit of Retirement Plan Administration*

Thank you for the opportunity to review and comment on the draft *Report on the Audit of Retirement Plan Administration (Report)*. I have discussed the draft with Bill Jones, Director of the Management Division; and other Management Division officers and staff; as well as with Governor Olson, Chairman of the Committee on Board Affairs. We are pleased that your audit did not reveal any significant control weaknesses, data discrepancies, or systemic processing errors. Further, we welcome your recommendations on actions to strengthen plan administration and oversight.

Our comments on your recommendations are presented below. With regard to those recommendations that require action by other System entities such as the Committee on Plan Administration (CPA), the Office of Employee Benefits (OEB), and the Conference of Presidents, we will work with our Federal Reserve System colleagues to fully examine the issues identified in the *Report*. We will inform you as final decisions are reached on the recommendations.

Specific Comments

1. **We recommend that the Board, through its representation on the CPA, modify the methodology for including lump sum payments in pension benefit calculations for members of the Board Benefit Structure.**

Concur. Board staff will work with the Committee on Plan Administration and the Office of Employee Benefits to ensure that lump sum payments are appropriately considered in future pension benefit calculations. Further, we agree that pension calculations for all Board Plan participants who have retired since January 1, 2002 should be reviewed to ensure that the retirees have received full credit for all eligible lump sum payments.

2. **We recommend that the Board, through its representation on the CEB and the CPA, revise the methodology for allocating OEB expenses.**

Concur in part. We agree that OEB expenses related to the Reserve Banks' consolidated health and welfare program should not be allocated to the Board since the Board does not

Appendix 1 – Comments from the Staff Director for Management (con’t)

participate in this program. We will ask the CPA to support a change in the expense allocation methodology to exclude these expenses from the Board’s assessment for 2003 and future years.

The report indicates that the current cost allocation methodology based on salary liability is “flawed.” Indeed, in 1999, the CPA reviewed alternative allocation methods and endorsed the continued use of the salary liability method. Nonetheless, a System work group is currently reviewing cost allocation alternatives, including ANP and salary liability, and will report its findings to the CPA. Since the CPA is responsible for selecting a cost allocation methodology, we will in the end rely on their decision.

3. **We recommend that the Committee on Board Affairs establish clear guidance for the continuing role of MGT staff to support retirement processing and to ensure that staff have access to Hewitt information commensurate with the level of support.**

Concur. Issues identified by the *Report* concerning the Management Division’s role in retirement processing will be shared with the Committee, and we will seek guidance and direction from the Committee on these issues.

4. **We recommend that the Board, in concert with the Conference of Presidents, strengthen oversight of the retirement plan by (1) amending the plan documents and By-Laws to create an audit committee composed of members of the CEB, CPA, and CIP; and (2) establish a written charter to clearly define the audit committee’s roles and responsibilities.**

We concur with the OIG that interaction and communication between the primary committees, including the sharing of audit reports, is key to effective oversight of the retirement plan. However, we do not believe that a separate audit committee is necessary. We are confident that the current governance structure and actions taken by the CPA in performing its oversight responsibilities, provides for independent and comprehensive audits of the retirement plan and appropriate communication of audit results to the CEB and the CIP. Nonetheless, we will consult with the Conference of Presidents regarding their position on the need for a separate audit committee and will inform you of our final decision.

cc: Darrell Pauley
H. Fay Peters

Appendix 2 – Comments from the Director of Reserve Bank Operations and Payment Systems



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

LOUISE L. ROSEMAN
DIRECTOR
DIVISION OF
RESERVE BANK OPERATIONS
AND PAYMENT SYSTEMS

July 14, 2003

Mr. Barry R. Snyder
Inspector General
Board of Governors of the
Federal Reserve System
Washington, DC 20551

Dear Barry:

Thank you for the opportunity to comment on your draft "Report on the Audit of Retirement Plan Administration." These comments focus on two of the draft report's recommendations: that the methodology for allocating OEB expenses be revised and that a new audit committee for OEB be established.

OEB Cost Allocation

The report concludes that it is inappropriate to allocate OEB thrift plan and retirement plan costs based on salary liability and that using ANP is a more equitable and defensible basis for allocating expenses. The OIG notes that it is classifying more than \$1.7 million as funds for better use, representing the difference in the Board's allocation between these two methodologies from 2002 to 2005 (projected).

We believe it is important that the final report acknowledge that, in any cost accounting framework, there may be a number of acceptable methodologies for charging out expenses, especially when expenses are not directly tied to usage. Salary and overall expense ratios, as well as staffing ratios, are common proxies used in the private sector for allocating joint costs. We do not believe that the current methodology for allocating thrift and retirement plan costs is manifestly unreasonable, and thus disagree that a portion of the Board's allocations should be classified as funds for better use. Moreover, this classification also does not recognize that, in other respects, the Board imposes disproportionate costs on the OEB because of the existence of the Board benefit structure.

Appendix 2– Comments from the Director of Reserve Bank Operations and Payment Systems (con't)

Rather than retroactively adjusting the current allocation methodology, we recommend that the System continue its reassessment of the charge-out methodology for OEB costs and benefits expenses more generally, which is already underway. This review will consider the merits of allocating OEB costs on bases other than salary liability, including the ANP basis you recommended. It may be desirable also to consider other approaches as part of this review, such as one that uses both active employees and retirees as the basis for the cost allocation. Since cost allocation methodologies generally need to be adopted in time to prepare budgets, any changes in the allocation of thrift and retirement plan costs that would result from this review would likely take effect in 2005.

The Federal Reserve takes its cost accounting processes very seriously and attempts to ensure that cost accounting is done in a way that provides for accountability, integrity, effective decision making, and efficiency. That said, the report should acknowledge that the methodology used to charge the Board and the Reserve Banks for OEB expenses has no material effect on the amount of net earnings paid to the U.S. Treasury. We believe the OIG's classification of certain OEB charges as questioned costs or funds for better use lead the reader to conclude otherwise.

OEB Audit Committee

The draft report recommends the creation of a separate audit committee for OEB, composed of members of the CEB, CPA, and CIP. We believe the establishment of yet another oversight committee for OEB is not warranted absent any evidence that the existing structure does not provide for effective, objective, and independent oversight of the OEB. The current governance structure was established following lengthy discussions among senior policymakers within the Federal Reserve, taking into account legal, fiduciary, and governance factors. The current structure relies on ongoing communications among the various groups, which we believe is occurring effectively. Based on our oversight of OEB and our liaison role to the CPA, we believe the current governance structure provides for robust, independent oversight of OEB, and do not believe the creation of a separate audit committee would likely enhance further the quality of this oversight.

I will provide, under separate cover, a number of more technical comments on the draft report.

Sincerely,

(signed)

c: Governor Olson
Steve Malphrus
Bill Jones
Fay Peters
Darrell Pauley
Dorothy LaChapelle
Joe Hayes

Appendix 3 – Principle Contributors to this Report

William L. Mitchell, Senior Program Manager

Ronald R. Braciak, EDP Auditor

Laurence A. Froehlich, Counsel to the Inspector General